



International Agricultural Trade Report

Weekly Market Report: Dairy, Livestock, & Poultry

January 29, 2001

The Impact of the Uruguay Round on the Global Trade of Nonfat Dry Milk.

Summary

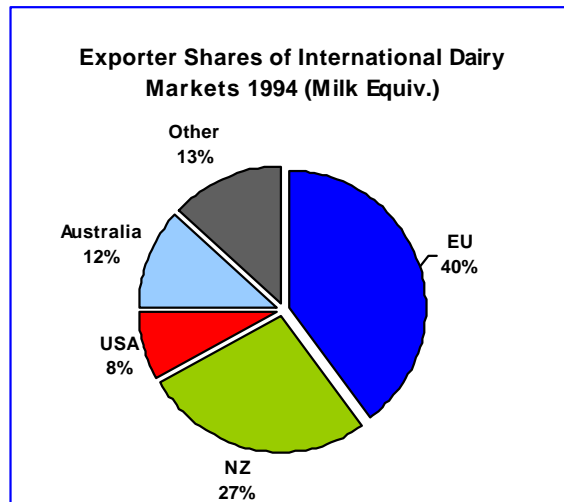
There is growing skepticism within the U.S. dairy industry as to whether forging ahead with another agreement liberalizing trade will present new opportunities to the industry or will simply risk further economic distress. This analysis aims to provide some insight into one part of the puzzle, the original contention that the curbing of trade distorting practices, primarily in the form of export subsidies on dairy products, would lead to higher prices.

In the Beginning

The original argument employed to garner support from the domestic dairy industry for the Uruguay Round (UR) agreement followed a simple logic. The European Union (EU), heavily dependent on export subsidies to hold around 40 percent of the global export market (on a milk equivalent basis), would be forced to withdraw gradually from world markets as its export

subsidies were reined in by the UR disciplines.

This action, coupled with global economic growth, would cause world prices to rise, narrowing the gap with U.S. domestic prices. With the 1996 FAIR Act dismantling dairy price supports by December 1999, the United States would rapidly transition into a global player, essentially settling into the marketing position traditionally held by the EU. This was to be especially true of nonfat dry milk (NDM) and, to a lesser extent, Cheddar cheese. The result would be a vibrant dairy industry no longer tied to a slow growing domestic market but expanding rapidly as a result of a dynamic export sector.



Not So Fast

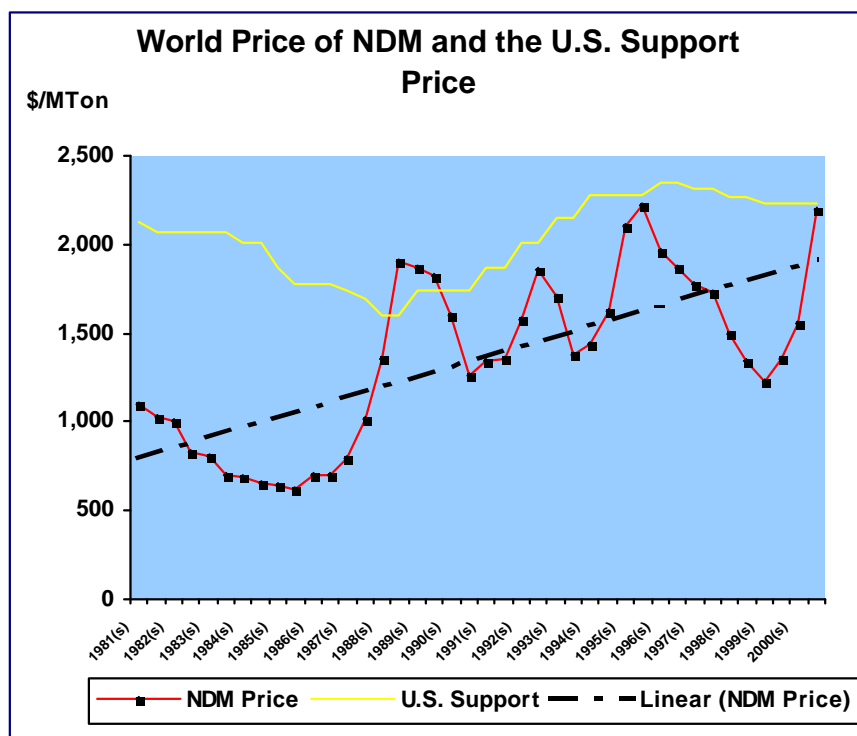
Unfortunately, the above scenario rapidly unraveled as world prices for NDM, having peaked in 1995 and 1996 as a result of drought in Oceania, dropped shortly thereafter. There were a number of factors at play. Perhaps the most significant was the correction in import demand in reaction to the high NDM prices. This was subsequently reinforced by the collapse of Asian economies in 1997. The rapidly devaluing currencies created a supply shock as prices of imported goods became prohibitive and import demand plummeted.

A Recovery in Sight

By early 1999, despite the accumulation of surplus stocks in the EU and the United States overhanging world markets, there were initial signs that a recovery was underway. For example, New Zealand had by January 1999 - unusually early - fully committed a large portion of its available exportable supply to customers. Further, by March 1999, the Dairy Export Incentive Program (DEIP) allocation for the United States was fully exhausted and yet world prices were stable. By the latter half of the year, NDM prices were firming and the EU was starting to release intervention stocks at an ever increasing pace. In fact, in the July-Dec. 1999 period, global prices for NDM climbed by nearly 19 percent. Subsequently they jumped by another 35-40 percent in the first 6 months of 2000 from around \$1,490/ton to approximately \$2,075/ton FOB. The magnitude of this increase was perhaps more astonishing given that the EU had nearly doubled

its volume of exports from the previous year and its surplus stocks - which stood at 270,000 tons in Sept. 1999 - were being rapidly depleted. Admittedly, this draw-down was obviously not just as a result of the frenetic export pace, but also of strong internal demand for dairy products.

Meanwhile, in the United States, the dairy price support program had been extended for an additional year effectively precluding commercial sales of NDM. Nevertheless, by July 2000 it was evident that demand



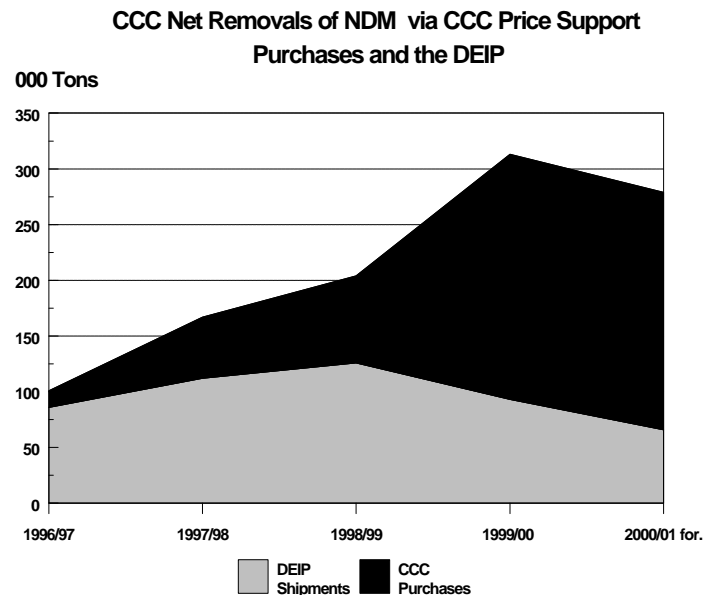
on world markets was sufficiently strong that the price differential between the U.S. internal and world market was razor thin. In fact, it was no longer possible to justify the award of DEIP bonuses and thus DEIP sales of NDM were halted. As a result, it is estimated that some 10,000 to 15,000 tons of unsubsidized NDM were exported in addition to the annual DEIP allocation of 68,201 tons.

In Terms of NDM was the UR Successful?

There are two indisputable facts that help frame a response to this question. First, the recent sharp increase in the export price of NDM has not been due to a major interruption in supply. Historically, a spike in global prices has almost always corresponded to an interruption in production, primarily due to drought.

This makes the recent escalation in prices unique. Second, in the absence of the UR limitations, the volume of NDM on world markets would have been far greater and prices lower.

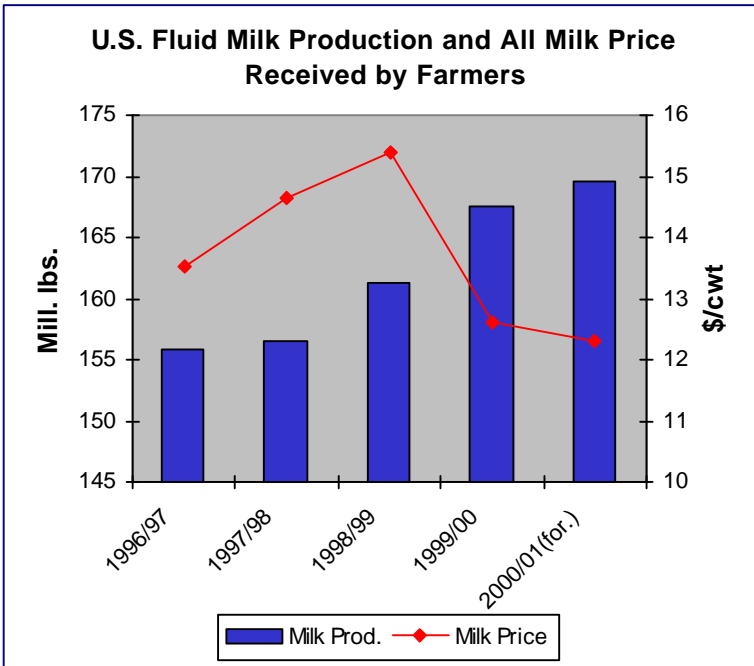
Suffice to note that during 1999/2000, USDA, via the CCC dairy price support program, purchased some 220,000 tons of surplus NDM. In effect, world markets are not short of product per se, they are short of subsidized NDM product.



Arguably, if U.S. price supports had been discontinued, the additional flow of NDM (now locked-up in CCC stocks) would have tempered the bullish world market. Perhaps, but to what degree? This becomes a complex issue since it touches upon the impact of low NDM prices on our own domestic consumption but also on the recent rise in U.S. imports of what are labeled by some as substitutes for NDM (e.g., milk protein concentrate, casein, etc.).

Conclusion: U.S. Dairy Industry Policy at a Crossroad

It is apparent that the UR limitations on export subsidies are having a profound impact on NDM markets. In fact, the high demand for NDM is spilling over into such products as whole milk powder, casein, whey, and, to a lesser extent, cheese and butterfat. The prices of all these products have strengthened during the past 12 months. But perhaps, equally important, is the role the UR is playing in internalizing trade distortions. In the past, any domestic surplus problems resulting from a government's intervention in the form of a price support program could be easily channeled into the export market via an export subsidy program or direct government sales. That is no longer the case. In this respect, the EU is ironically better positioned than the United States in that EU dairy policy has long recognized that price supports alone can stimulate over-production that quickly becomes untenable and ultimately incompatible with its UR commitments. Consequently, milk production has been capped by quotas and the price support tools in the form of annual intervention purchases that are not only limited in price but also in volume and validity. The sharp reduction in EU stocks of NDM not only reflects the fortunate rebound of the world market and use of the controversial "rollover" provision but also the fact that stagnant production (as a result of quotas) is set against a backdrop of rising internal consumption.



In the U.S. dairy industry, the thorny issue of price supports is becoming more contentious as the growing surplus volumes of NDM become alarmingly visible. The key question for policy makers is how to restrain production when markets are oversupplied and yet provide farmers with an adequate “safety net.” Given the climate of uncertainty it is not surprising that the dairy industry is skeptical and concerned about the potential outcome of future trade negotiations.